NSIAD-89-12

United States General Accounting Office

GAO Testimony

For Release On
Delivery
Expected At
9:30 a.m. EST
Tuesday
March 7, 1989

Foreign Trade Zones Program Needs Clarified Criteria

Statement of Ailan I. Mendelowitz
Director, Trade, Energy, and Finance Issues
National Security and
International Affairs Division

Before the
Subcommittee on Commerce, Consumer,
and Monetary Affairs
House Committee on Government Operations

GA 1.5/2:

Mr. Chairman and Members of the Subcommittee;

I am happy to be here today to discuss with you our review of the Foreign Trade Zones (FTZ) program which was undertaken at the request of Representative Dan Rostenkowski, Chairman of the House Ways and Means Committee. We issued a report on the program in February[1] and today I will highlight our major findings, concentrating on the recent rapid growth of trade zones activity and the criteria and processes used by the Foreign Trade Zones Board to award zone grants.

DRAMATIC GROWTH AND CHANGE IN ZONE ACTIVITY

Recent dramatic growth and change in the FTZ program, particularly the movement of automakers to a dominant position, has aroused controversy over the program's economic effects. Opponents are concerned that savings from zone procedures may encourage the import of foreign parts for products manufactured in the zones, thus damaging domestic suppliers and the U.S. economy generally. Zone users claim the savings enhance their overall competitiveness and specifically help them to compete with imported end products.

To encourage U.S. participation in international trade, the Foreign Trade Zones Act of 1934 authorized the designation of secured zones

---

[1]International Trade: Foreign Trade Zones Program Needs Clarified Criteria (GAO/NSIAD-89-85).

READEX FICHE best copy available

at ports of entry within the United States that are legally considered outside U.S. customs territory. The FTZ Board, composed of the Secretaries of Commerce, Treasury, and the Army, approves proposed zones and shares responsibility for monitoring and controlling them with the Customs Service. Companies operating in a foreign trade zone may escape, postpone, or reduce tariffs and other restrictions on foreign goods that enter the zones. They may reexport zone products without incurring tariffs or send them into the U.S. market after paying applicable duties.

A key benefit of zone status stems from the opportunity to escape inverted tariffs on imported parts used in goods destined for the domestic market. In inverted tariff situations, duty rates on finished products are lower than the rates on their component parts. Although some inverted tariff relationships were deliberately created, others, including that in the auto industry, were apparently unintentional by-products of tariff reductions negotiated under the auspices of the General Agreement on Tariffs and Trade. By postponing duty assessment until zone products actually enter U.S. customs territory, firms in certain industries may reduce the tariff rates that would apply to the component parts to the lower rate on the finished product.

For 35 years the FTZ program generated very little activity. By 1970 only 10 zone grants had been made and in that year only $100 million worth of goods passed through all zones. By 1987, however,

239 grants had been made. Goods valued at nearly $40 billion (including $8.8 billion of imports) were received in the zones in 1986 and 89 percent of zone shipments entered the U.S. market. This growth, while related to changing economic conditions, was more directly caused by a series of key legislative and regulatory actions that made zone status more attractive for manufacturing firms.

The 1950 Boggs Amendment to the Foreign Trade Zones Act allowed participating companies, for the first time, to manufacture and exhibit products within zones. The fact that the amendment could lead to increased imports was viewed as positive in light of the U.S. trade surplus at that time and post-World War II efforts to revive the European economy. This amendment was not expected to lead to significant manufacturing within zones, primarily because of the cost of locating factories in cramped, expensive port areas. However, the FTZ Board removed this constraint in 1952 by authorizing the creation of subzones which may be located some distance from sponsoring general purpose zones.

Despite these changes, the zones program remained relatively small through the 1970s, which ended with 45 general purpose zones and 6 subzones. Two regulatory decisions made in the early 1980s significantly increased the potential duty savings for manufacturing in zones. In 1980 the Treasury Department excluded the value added in zones from the dutiable value of finished

products to encourage foreign auto firms and other industries with inverted tariffs to locate in the United States. In 1982 the Customs Service further reduced the dutiable value of finished products by excluding brokerage and insurance fees and transportation costs from their calculation.

The numbers of authorized general purpose zones and subzones rapidly expanded in the 1980s. Although a precise estimate is impossible, it appears that about 90 percent of the economic activity within the zones in 1986 took place at manufacturing firms whose interest in the program was, at least in part, the avoidance of inverted tariffs.

The most significant change in the character of the program has been the movement of the U.S. auto assembly industry into subzones. Thirty-six of the 101 subzones authorized by the end of fiscal year 1987 consisted of auto assembly plants, and more auto assembly applications were pending. About 80 percent of U.S. auto assembly plants were located in subzones, and during 1986 they accounted for about 85 percent of all goods received in zones. The most important motivation for auto firms is the opportunity to reduce imported parts tariff, which average 4 percent but range as high as 11 percent, to the 2.5 percent rate on completed autos. Firms in several other industries with inverted tariffs, including shipbuilding, office equipment, and heavy equipment, have also obtained subzone status.

NEED FOR CLARIFIED CRITERIA FOR ZONE GRANTS

The Foreign Trade Zones Act, as amended, contains minimal guidance for evaluating grant applications. It states that designated "ports of entry" are each entitled to at least one zone and that grants shall be made if the proposed plans and location are suitable to expedite and encourage U.S. participation in international trade. The FTZ Board may exclude from zones any goods or process that it judges detrimental to the public interest, health or safety. The Act provides no explicit basis for denying applications, although the FTZ Board may revoke grants for "repeated willful violations" of the Act.

The FTZ Board's regulations, last revised in 1971, provide that zone and subzone grants will be made if an economic survey demonstrates to the satisfaction of the Board that the anticipated commerce, benefits and returns, both direct and indirect, will justify construction of the proposed zone. However, the Board informally relies on more detailed criteria contained in 1983 draft regulations to evaluate applications, particularly for subzones. Building on the Act's public interest provision, the 1983 draft defines subzones as ancillary sites to be authorized when it can be demonstrated that the proposed activity will result in a significant public benefit.

While the FTZ Board advises applicants that the 1983 draft regulations should be consulted as guidance in preparing their applications, it has not strictly adhered to them. Proposed subzones are generally approved if applicants show that the projected benefits will justify their effort and expense in establishing and using zone procedures and the Board finds no substantial evidence of potentially offsetting negative effects. The public benefit concept remains ill-defined in practice. While some applicants clearly state that grants will contribute to retention or expansion of U.S production and/or employment, the FTZ Board has not required a rigorous demonstration of a significant public benefit. For example, applicants have not been required to show that FTZ benefits are a determining factor in attracting or keeping plants in the United States. The Board has deemed it sufficient for applicants to claim that zone savings help in meeting foreign competition.

In many cases, the impact of proposed subzones on suppliers or competitors has not been established; the absence of opposition is often taken as sufficient evidence that proposed subzones will not have significant adverse effects on these parties. Although the 1983 draft regulations call for consideration of "public costs" in evaluating applications, the Board does not give explicit consideration to the potential loss of tariff revenues. While estimates of such revenues foregone vary, the International Trade

Commission estimated that companies in zones reduced their tariff expenditures by about $38 million in 1986.

When a proposed zone is opposed by affected industries or federal officials responsible for relevant trade policy measures, the FTZ Board informally seeks compromise solutions acceptable to both sides. By the end of fiscal year 1987, the Board had placed one or more conditions on manufacturing activity in 36 subzones or general purpose zones. Most of the time, these restrictions limit operations to export only, limit the duration of a grant, or stipulate that zone users cannot reduce duties or avoid other import restrictions on parts used to manufacture products for sale in the United States. It is Board policy that it would not be in the public interest to allow grants to circumvent or undermine trade policy measures taken to protect domestic industries. The Board seldom denies applications, however, and appears hesitant to act when applicants reject restrictions, thus allowing applications to remain pending for long periods.

The FTZ Board has continued to approve subzones for the auto industry, although it seems clear that the marginal savings obtained through zone procedures--typically $10 or less per car for domestic producers and up to $50 per car for foreign-affiliated auto assemblers--neither provide U.S. plants with a meaningful competitive advantage against imported cars nor a significant incentive for locating production facilities in this country rather

than overseas. The desire to avoid potential protectionist measures and the pressures of exchange rate changes are clearly the major incentives for locating plants in the United States. For auto makers, as well as other types of participating firms, savings from zone operations make only a very small contribution to applicants' efforts to meet foreign competition, a contribution whose effects on employment and production probably cannot be measured.

The effects of auto plant subzone grants on auto parts suppliers are unclear. However, it is clear that the FTZ Board's actions in this sector have resulted in a reduction in federal tariff revenue collections. The movement of the auto industry into subzones has resulted in the United States, in effect, unilaterally lowering tariff rates on parts without attempting to obtain compensating tariff reductions from other countries.

The Board's hesitancy in either adopting or enforcing a strictly defined public benefit test may be attributable to the lack of clarity in the Foreign Trade Zones Act on the character of the criteria to be applied in judging applications. Although the Act permits restrictions to be imposed in the public interest, it provides minimal guidance for deciding whether grants should be made in the first place. The dominance of manufacturing in subzones together with a focus on selling in the U.S. market, developments that were not likely foreseen when the Act was

originally passed or when it was amended in 1950, indicate that the Act's minimal guidance may no longer be adequate.

The Congress should amend the Foreign Trade Zones Act to provide guidance on the nature of significant public benefits that would justify a foreign trade zone or subzone grant and any related tariff revenue loss. The amendment should specify factors to be considered, such as exports, imports, employment, and investment, and could be modeled after the draft regulations already developed by the FTZ Board.

Mr. Chairman, the principal outcome of our work was the suggestion for legislation to guide the Board's evaluation of zone applications. Before I close, however, I would like to provide our observations on some other aspects of FTZ administration.

PROGRAM ADMINISTRATION

Dramatic growth in the FTZ program, together with increasing controversy, has strained the ability of the FTZ Board's three member professional staff to expeditiously process applications and monitor activity in established zones. In 1978-79 the average time required by the Board to act on applications was 6 months, but doubled to 12 months for applications filed during 1984-85. As of October 1987, 34 of 56 subzone applications filed during the previous 3 years remained unresolved, having been in pending status

for an average of almost 17 months. The small size of the Board's staff has allowed very limited on-site monitoring of zone activities, so it has relied on review of grantees' annual reports for this purpose. However, these reports are of limited use in assessing whether zones continue to serve the public interest.

Our report recommended to the Secretary of Commerce that he consider providing the FTZ Board with additional professional staff from existing resources within the Department on at least a temporary basis to relieve the backlog of applications and facilitate the adoption of new regulations. The Department of Commerce 1990 Budget Request includes three additional professional staff for the Board.

Our limited inquiry into the Customs Service procedures did not provide us with a basis for reaching general conclusions about their adequacy and effectiveness for controlling zone activity and enforcing relevant tariff and trade laws. Customs relies on an audit-inspection system wherein zones maintain their own records, subject to Customs review, as the basis for administration of tariff and trade laws. Customs allocated 10 full time equivalent staff years to conduct spot-check inspections of zones in 1987 and devoted 3.7 staff years to comprehensive zone audits completed in that year. Given this level of resources, it is not clear whether Customs can meet its own standards regarding the appropriate frequency of inspections and audits for the 100-plus active zones

and subzones. Customs is currently assessing its zone supervision program, focusing on manufacturing subzones.

The Omnibus Budget Reconciliation Act of 1987 eliminated the former requirement that zone operators pay the cost of additional Customs Service resources required to supervise zones. The Treasury Department advised us it expects to pursue legislation to reinstate these user fees.

- - - - - - -

Mr. Chairman, this concludes my prepared statement, and I will be happy to respond to any questions you may have.